Entrepreneurs first

economic LETTER

JULY 2012 – AUGUST 2012

IS CANADA EXPERIENCING A HOUSING BUBBLE, OR JUST A BALLOON?

The low interest rates that have held sway in Canada for the past several years have stimulated the housing market enormously. Activity has been sustained in both the resale market and that of new homes, and prices have climbed significantly, to the point where many players, in particular the Bank of Canada, are worried about a possible correction in the housing market. The OECD has even warned Canada about this, recommending that it "continue to closely monitor developments and risks in housing markets and household debt."[1] Indeed, just recently, the federal government imposed stricter mortgage rules in an effort to calm the real estate market, including shortening the maximum amortization period for mortgage loans.

Opinions about the existence of a bubble in the Canadian real estate market vary widely. The Canada Mortgage and Housing Corporation (CMHC) feels that the market is supported by favourable economic and demographic factors, such as employment, net migration and low interest rates, and that only certain sectors merit a closer watch. Many other observers share that view. In fact, it is only in the multiple dwelling segment – especially condominiums – that residential construction has been exuberant in recent years, since starts of single-family dwellings have stabilized since 2010 (see graph). Moreover, the boom is limited to the major urban centres, in particular Toronto, Montreal and Calgary. In Vancouver, activity has already calmed somewhat, and prices have started to decline. The analysts at BMO report that in Toronto and Vancouver, condo sales on the resale market in June were nearly 20% lower than a year ago.[2]

An increase in housing starts, even if it is strong and sustained, does not necessarily signify a bubble in the market. We must examine a host of indicators to determine whether that is the case: trends in new home prices, the situation in the resale market (supply versus demand, inventory and prices). We must also dissect the data to determine which sectors, if any, are at greatest risk.

Desjardins has just published a study on the Quebec condo market, based on an analysis of this type of indicator.[3] Between April 2011 and April 2012, condo starts soared by 83% in the Montreal Census Metropolitan Area (CMA), which ▼

1 OECD Economic Surveys: Canada, Overview, June 2012, page 18.
2 BMO Economic Research, Econofacts, Canada Housing Starts, July 10, 2012.
3 Desjardins, Economic Viewpoint, Quebec Condo Market, July 10, 2012.

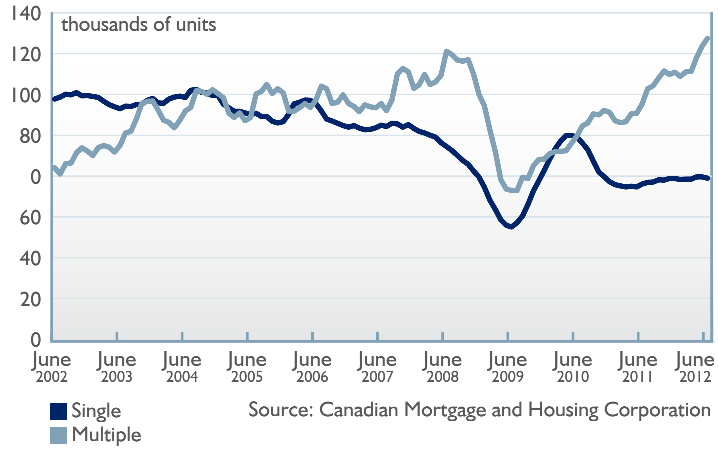
BDC's Monthly Economic Letter is prepared by the Economic Analysis team from Marketing and Public Affairs and is based on a variety of public sources of economic data. The information in this letter is drawn from data released prior to July 19. Reliance on and use of this information is the reader's responsibility.

provides grounds for concern. The Desjardins analysis shows that the market in the Montreal CMA is balanced overall, but that it is in a surplus position in the high-end condo segment (over $800,000) and in certain geographic areas, particularly downtown Montreal, and it may have trouble absorbing the new units that will be appearing on the market.

Indeed, it is quite probable that the market will be saturated in major urban centres like Montreal and Toronto, once the numerous condos currently under construction are completed. And it would not be surprising to see, if not a decline, at least a definite slowdown in the growth of housing prices when that happens. But, to adopt a metaphor used by Sherry Cooper, Chief Economist at BMO, there is more likelihood of seeing the deflation of a balloon, rather than the bursting of a bubble.

What is actually more worrisome is that residential construction has been playing a key role in GDP in recent years. If it drops back to a level closer to its historical average, real GDP will have to find new sources of growth. Given the indebtedness of households and governments, we cannot rely too much on consumption and government spending to support the economy. And given the slowdown in the global economy, the contribution by foreign trade is likely to be lacklustre. This means that future growth will mainly rest on the shoulders of private businesses that invest in fixed capital (machinery, materials and non-residential construction). Let's hope they are strong enough to bear the burden. ■

Canada Housing Starts
(June 2002 to June 2012: 6-month moving average)



CANADA

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The second quarter started off with an acceleration in real GDP growth in April. Meanwhile, residential construction held steady during the quarter, defying expectations of a slowdown. On the other hand, employment has remained flat in the past few months, and the trade deficit has widened; these factors bode less well. The central bank has revised its growth forecasts for 2012 slightly downwards, and forecasters anticipate that the key interest rate should not rise before mid-2013.

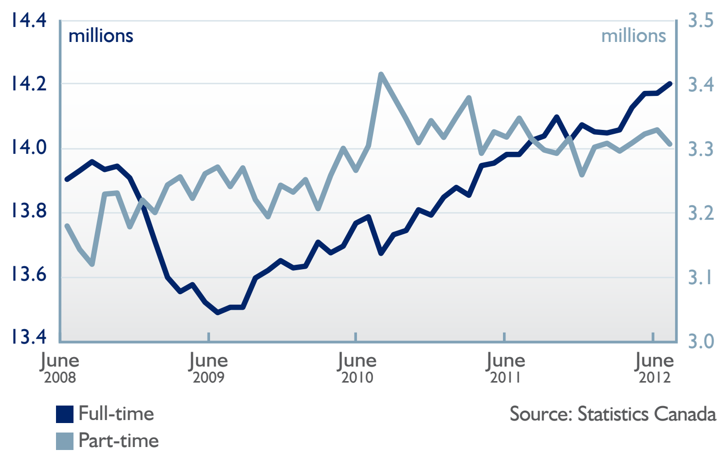
Real GDP by industry advances

Real GDP by industry rose by 0.3% in April, compared with the previous month. The increase is largely attributable to mining, petroleum and gas extraction, which rebounded (2.7%) after a two-month slump and, to a lesser extent, wholesale trade, which recorded its fifth straight monthly advance (1.2%). Retail trade suffered the biggest setback (-0.8%), while manufacturing was down slightly (0.3%). April's numbers are getting the second quarter off to a good start.

Employment stalls

Employment remained practically static for the second month in a row, recording a slight increase of 7,300 jobs in June after similar growth of 7,700 jobs in May. A gain of 29,300 full time jobs was offset by a loss of 22,000 part-time jobs. Business, building and other support services recorded the strongest monthly gain (24,200), while information, culture and recreation suffered the largest downturn (-22,000). The unemployment rate dropped slightly, from 7.3% in May to 7.2% in June, due to a contraction in the labour force. Despite flagging job creation in recent months, the job market is in better shape than it would seem, since it is part-time employment that is stagnating; full-time jobs are still rising (see graph). ▼

Full-time and Part-time Employment
(June 2008 to June 2012)



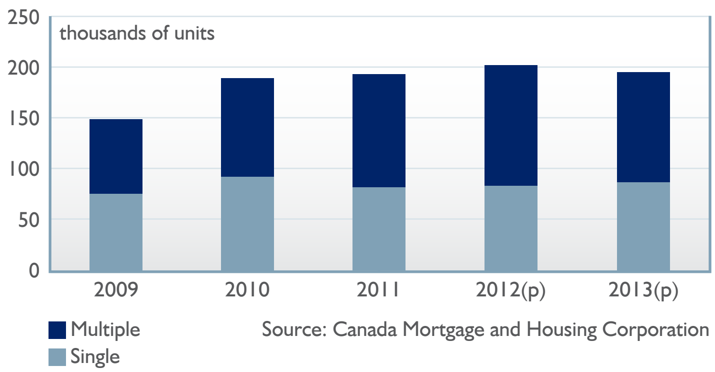
The trade deficit widens

Exports were stable in May compared with the previous month, while imports rose by 0.4%, so the trade deficit expanded from $623 million in April to $793 million in May. The increase in exports of machinery and equipment nearly cancelled out the declines recorded in most of the other major sectors. On the imports side of the equation, the expansion comes mainly from the energy sector. Automotive products also contributed to the increase, but to a lesser extent. After four consecutive monthly drops, exports to the United States ticked up slightly, but imports from that country climbed more markedly, with the result that Canada's trade surplus with the United States narrowed, from $3.6 billion in April to $3.2 billion in May. On the other hand, Canada's trade deficit with countries other than the United States improved, from $4.2 billion in April to $4.0 billion in May.

Housing starts rise, sales of existing homes fall

The number of housing starts spurted up, from 217,400 units in May to 222,700 units in June. Once again, the surge comes from the multiple-unit segment. Housing starts in urban centres declined slightly in the single-family segment (-0.3%), while climbing in the multiple-unit segment (4.1%), especially in Quebec and British Columbia. The CMHC is still anticipating a slowdown in the pace of housing starts between now and the end of the year (see graph). Meanwhile, home sales fell 1.3% month-over-month in June 2012, after a 3.4% drop in May. According to the Canadian Real Estate Association, the decline in sales, combined with a slight increase in new listings, resulted in a more balanced housing market nationwide in June.

Housing Starts
(historical data and forecasts)



UNITED STATES

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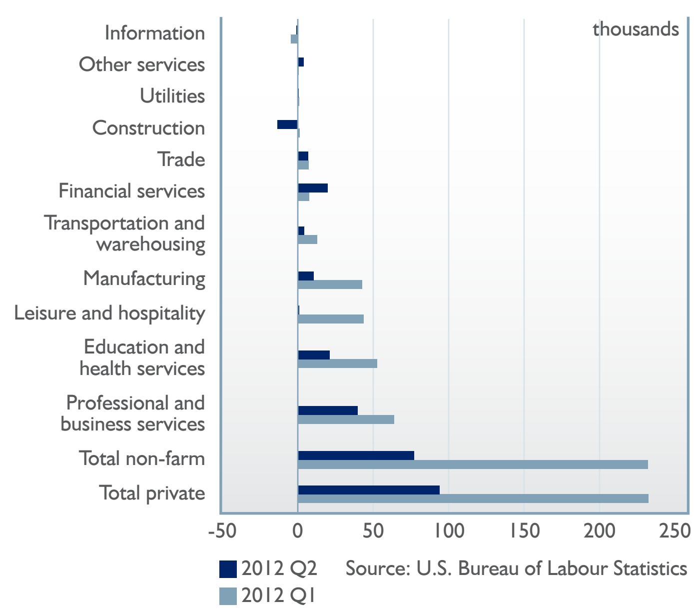
The most recent economic indicators are nothing to smile about: job creation has slowed significantly, as has consumption. Business confidence is down. Housing starts gained ground in June, but the recovery in the housing market is still excruciatingly slow. It comes as no surprise that the consensus for real GDP growth between May and July 2012 has been revised downwards, from 2.3% to 2.1%.

Employment stagnates

Job growth was limp again in June, with just 80,000 new jobs. The average monthly variation in employment plummeted from 226,000 in the first quarter to 75,000 in the second. The vast majority of sectors recorded slowdowns from the first quarter to the second (see graph). In the leisure and hospitality sector, for example, the increase went from a monthly average of 42,000 new jobs in the first quarter to just 1,000 in the second. The construction sector lost 13,000 jobs on average in the second quarter, after an average gain of 1,000 in the first. The unemployment rate remained stable at 8.2% in June. Many observers expect to see only slow improvement in the job market: the consensus is calling for an average unemployment rate of 8.1% for 2012.

Change in employment, by sector
(average monthly change in 2012Q1 and 2012Q2)



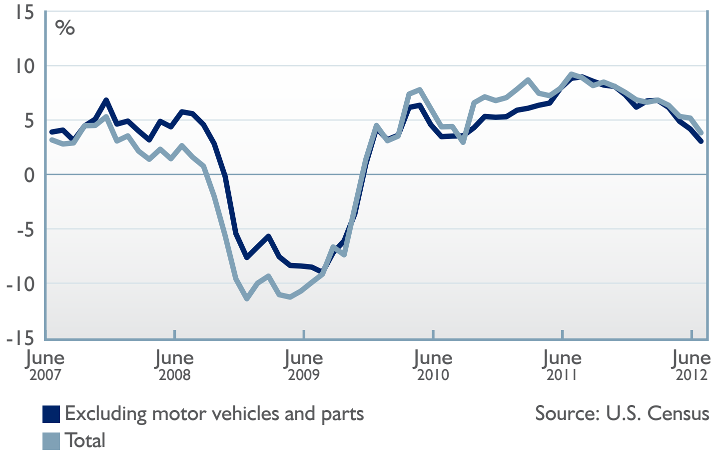
The housing market advances at a snail's pace

Housing starts spurted up by 6.9% in June compared with the previous month. The single-family segment saw an increase of 4.7%, while that of multiple units soared by 17.0%. Home-building activity is recovering, but at an extremely slow pace. In the real estate market, sales of existing homes dropped by 1.5% in May compared with the previous month. At the current pace of sales, it would take 6.6 months to sell off the inventory of homes listed for sale. The resale market has stabilized, but is only gaining ground inch by inch.

Consumption slows

Retail sales slipped by 0.5% in June compared with the previous month, and by 0.4% if we exclude sales of motor vehicles. Nearly all trade categories saw a slump in sales in June. Annual retail sales growth has plunged in the past 12 months, from a peak of 9.2% in June 2011 to a mere 3.8% in June 2012 (see graph).

Retail Sales
(year-over-year change)



Business confidence declines

The Institute for Supply Management's Purchasing Managers' Index for the manufacturing sector, which measures business confidence in that sector, fell below the 50% mark in June for the first time since July 2009. At 49.7%, the index signifies contraction in the manufacturing sector, while continuing to indicate expansion in the overall economy (this is what is meant by a figure above 42.6% over several months). This drop in the index is mainly attributable to the new orders component, which lost 12.3 points from May to June, coming in at 47.8%.

INTEREST RATES

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The key interest rate should not rise before June 2013

The Bank of Canada has left its key interest rate right where it has been sitting since September 2010, i.e. at 1.0%. The central bank believes that economic growth will be supported by consumption and business investment, which are still enjoying very favourable financial conditions, but that it will be restrained by "global headwinds" such as lower commodity prices, weak foreign demand and a strong Canadian dollar. The Bank has revised its growth forecasts for 2012 from 2.45 to 2.1%, but still mentions that it will eventually have to raise interest rates, while remaining vague about the timing and scope of such monetary tightening. The vast majority of forecasters do not expect any hike in the key interest rate before mid-2013.

OIL AND THE LOONIE

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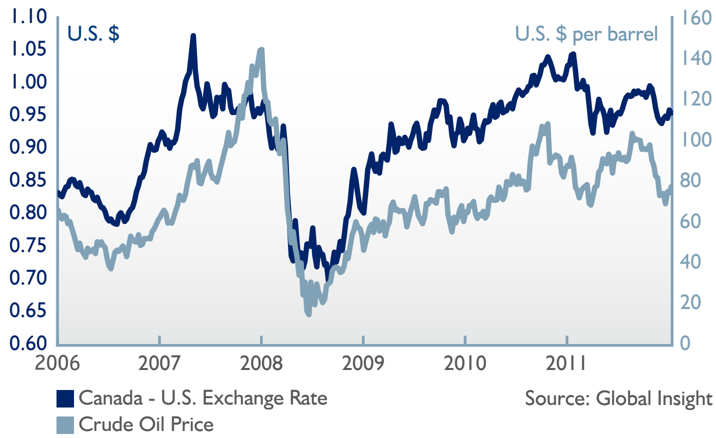
The price of oil edges up and the Canadian dollar follows suit

After dropping sharply in May and June due to growing concerns about Europe's debt problems, the price of crude oil edged up in July due to the tense conditions in Egypt, which spark worries about a contraction in supply. Egypt is not a key producer, but it is home to two strategic channels carrying Middle East crude from the Red Sea to the Mediterranean: the Suez Canal and the Suez Mediterranean pipeline. The upwards movement was held in check, though, by oil market conditions in the United States, where reserves of crude have been building up in the terminal in Cushing, Oklahoma. The Canadian dollar appreciated slightly in response to the higher price of oil.

Crude Oil Price and Canada - U.S. Exchange Rate



Source: Global Insight

SME CONFIDENCE

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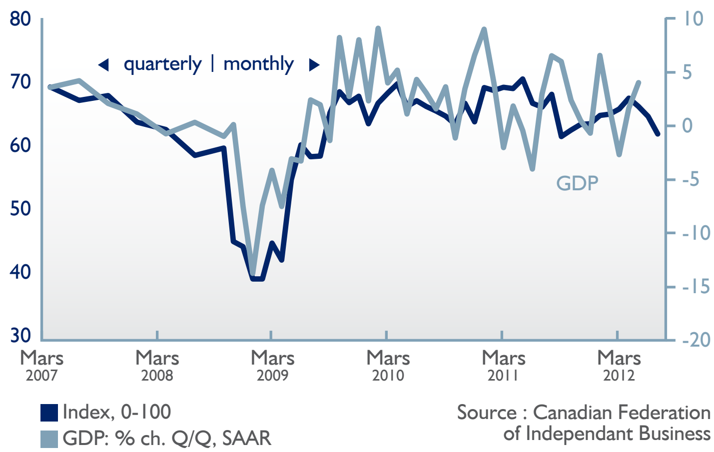
Business confidence is shaken by the European crisis, but outlooks remain favourable

Small and medium-sized businesses continue to worry about global economic outlooks: the CFIB's Business Barometer lost ground in June for the third straight month, coming in at 62.1% (see graph). This is its lowest level since August 2011, when the index dropped sharply in reaction to the mounting sovereign debt crisis in Europe. On the other hand, the Business Outlook Survey, which covers small and medium-sized businesses as well as large corporations, indicates that growth outlooks were still favourable in the second quarter, despite concerns about the European crisis.

CFIB Business Barometer and Real GDP Growth
(Index of 50 = equal balance of stronger and weaker business expectations)



Source : Canadian Federation of Independant Business

BUSINESS CREDIT CONDITIONS

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Business credit conditions ease, generally speaking

The Bank of Canada's Senior Loan Officer Survey indicates that business credit conditions eased further in the second quarter, compared with the previous quarter. On the other hand, the Business Outlook Survey reports somewhat tougher credit conditions in that period. It is mainly small and medium-sized businesses that report less favourable lending conditions, while large corporations, in general, continue to report easing. Business loans granted by the chartered banks nevertheless expanded by 11.1% in May compared with the previous month; short-term credit rose by 10.4%, while long-term credit escalated by 16.2%. ■

Business Credit Conditions
balance of opinions (%)

KEY INDICATORS – CANADA

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Key indicators – Canada	Historical				2012				Latest		Forecasts	
	2008	2009	2010	2011	Q1	Q2	Q3	Q4			2012	2013
Real GDP (% growth)	0.7	-2.8	3.2	2.4	1.9				Apr	0.3	2.1	2.2
Machinery and Equipment Expenditures (% growth)	-0.5	-19.5	11.8	12.5	4.0						3.1	6.6
Pre-Tax Corporate Profits (% growth)	11.0	-33.1	21.2	15.4	-10.0						4.0	4.8
Industrial Production (% growth)	-3.1	-9.5	4.9	3.5	-1.0				Apr	1.0	2.0	2.8
Industrial Product Prices (% growth)	4.3	-3.5	1.0	4.6	0.7	1.0			Apr	0.0	1.1	1.9
Non-Residential Construction (% growth)	7.9	-22.2	2.8	13.7	5.7							
Housing Starts (' 000 units)	212	148	191	193	206	231			Jun	223	201	183
Personal Expenditures (% growth)	3.0	0.4	3.3	2.4	0.9						1.9	2.1
Consumer Price (% growth)	2.4	0.3	1.8	2.9	2.1				May	-0.1	1.9	2.0
Employment (% growth)	1.7	-1.6	1.4	1.5	0.9	2.8			Jun	0.0		
Unemployment Rate (%)	6.1	8.3	8.0	7.5	7.4	7.3			Jun	7.2	7.3	7.1
SMEs Confidence Index (CFIB)	56.1	57.7	66.7	66.4	66.3	64.4			Jun	62.1		
Manufacturers Confidence Index (CFIB)	52.7	56.0	68.6	67.2	69.0	67.2			Jun	66.3		

Sources: Statistics Canada, Consensus Economics and Canadian Federation of Independent Business. Annual growth, quarterly growth at annual rate and month-over-month growth.